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COUNCIL FOR BUDGET RESPONSIBILITY

# Evaluation of Compliance with the Balanced Budget Rule in 2015

*Summary*

December 2016

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This report presents the official positions of the Council for Budget Responsibility in line with its mandate laid down in Act No. 523/2004 on the general government budgetary rules and Act No. 493/2011 on fiscal responsibility.

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Any suggestions or comments on the report are welcome at sekretariat@rrz.sk.

# Evaluation of Compliance with the Balanced Budget Rule in 2015

The balanced budget rule[1] is based on the medium-term objective – a structural balance which Slovakia's public finances should attain or should be quickly approaching to. The evaluation of compliance with the rule falls under the responsibility of the Ministry of Finance ("the Ministry") which publishes its reports biannually, by 30 June and 30 November. Subsequently, the Council for Budget Responsibility ("CBR") provides its independent evaluation. In line with the principles published by the European Commission[2], the Ministry then publishes its position on the CBR evaluation.

The CBR prepared its final evaluation of compliance with the balanced budget rule for the year 2015 based on the data contained in the October deficit and debt notification by Eurostat. It also contains CBR's response to the evaluation published by the Ministry on 30 November 2016. No change was made in the evaluation methodology; the only significant change against the CBR's July evaluation is the exclusion of time-adjusted corrections to EU funds from one-off effects[3].

**The structural general government deficit stood at 2.7 % of GDP in 2015, i.e., the medium-term objective of having a nearly balanced budget (structural deficit not exceeding 0.5 % of GDP – Figure 1) was not accomplished. The development in the structural balance and adjusted expenditures, even after taking into account additional factors, proved a significant deviation from the set adjustment path towards the 2017 medium-term objective. Having considered all relevant factors, the CBR holds that a significant deviation from the adjustment path occurred in 2015 and that it would be necessary to trigger the correction mechanism.**

**Since 2012, the cumulative deviation from the adjustment path which would ensure that the originally set medium-term objective is achieved by 2017 has amounted to nearly 0.6 % of GDP (Figure 2).** Compared with 2012, the 2015 structural balance improved by overall 1.8 % of GDP, which is 0.6 % of GDP below the required change of 2.4 % of GDP assuming steady deficit improvements by 0.8 % of GDP per year. The entire budget consolidation took place in 2013 when the balance improved considerably (by 2.2 % of GDP), followed by fiscal easing in 2014 and stagnation in 2015. As part of its overall evaluation, the CBR also factored in the effects of other factors which increase the significant deviation up to the level of 2.2 % of GDP. They namely involve the effect of lower contributions to the fully-funded pillar of the pension system by 0.3 % of GDP, which do not contribute positively to the budgetary position in the long term[4], and a positive impact of windfall revenues amounting to 1.3 % of GDP.

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[1] The rule was transposed into Slovakia's national legislation on the basis of an obligation arising under the international Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. The first evaluation was presented in 2014 (for 2013).

[2] Communication from the Commission: Common principles on national fiscal correction mechanisms of 20 June 2012 (/* COM/2012/0342 final */). The "comply or explain" principle.

[3] In order to quantify the size of the structural balance as precisely as possible, the CBR has so far considered time-adjusted recording of corrections to EU funds in its evaluations (i.e., corrections recorded in the period in which a particular project subject to corrections was implemented, instead of recording them in the period when a decision on the correction was made). The process of verifying the correct use of EU funds have proved demanding, with the amount of corrections corresponding to a given period of time liable to change even several years after the closure of a programming period. On that account, the data necessary for the time-adjusted recording of corrections are not available at the time of evaluation, namely 1/ the complete information about the time-adjustment of existing or projected corrections, and 2/ the estimate of future corrections that may be retroactively assigned to 2015. Therefore, the CBR's structural balance estimate took into account the actual level of corrections under the ESA2010 methodology, i.e., without time adjustments. Similarly to its July report, the CBR included potential deviations caused by the missing data on the adjustment of present corrections (improving the structural balance) and the missing estimate of future corrections (worsening the structural balance) among additional factors without quantification. This change, therefore, has no effect on the CBR's final evaluation compared to its July report.

[4] For example, the reduced contribution rates to the fully-funded pillar should be reflected in a more stringent medium-term objective.

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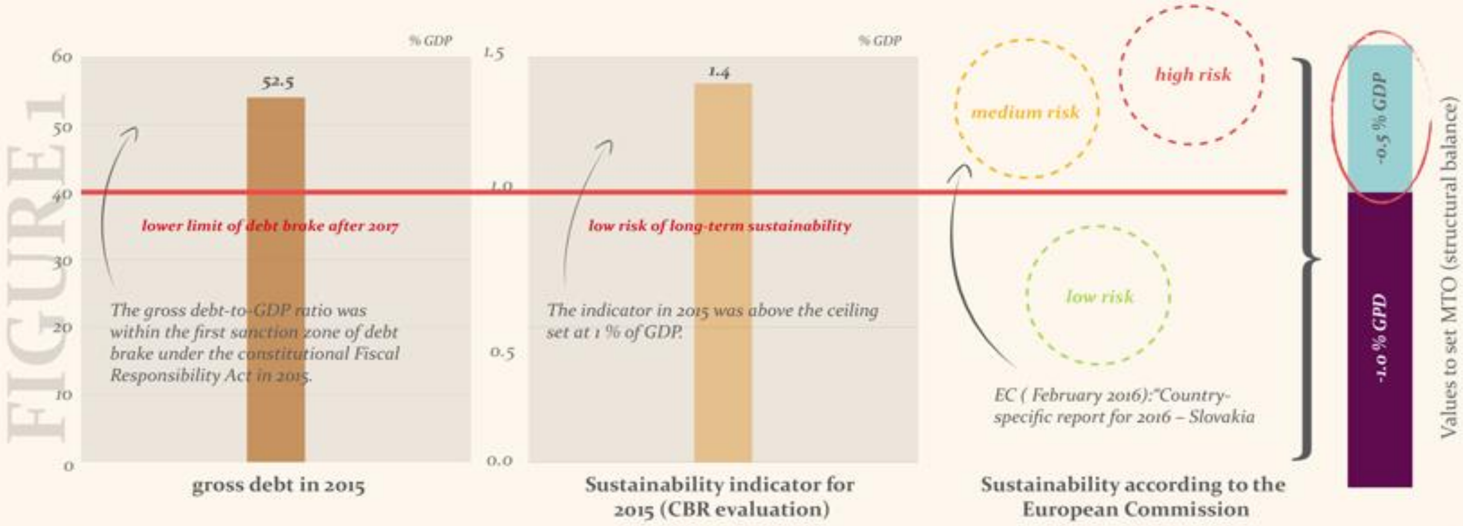
# Structural balance

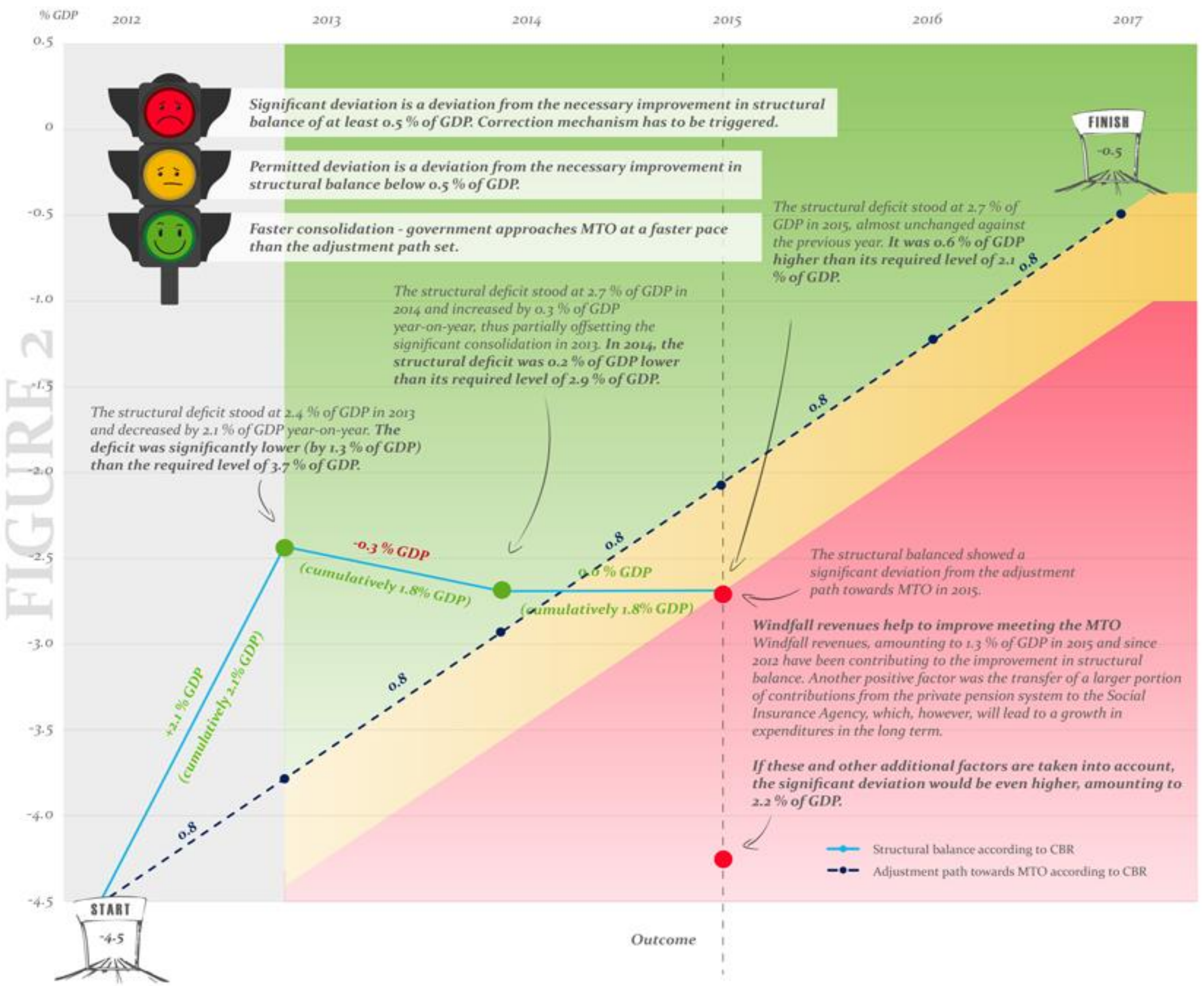
## Given the level of the debt and long-term risks, a more stringent MTO has been set – structural deficit of 0.5 % of GDP.

FIGURE 1




*The general government structural deficit stood at 2.7 % of GDP in 2015, i.e., the medium-term objective of attaining a close to balanced budget (structural deficit up to 0.5 % of GDP) was not achieved.*

FIGURE 2



**The growth in adjusted budgetary expenditures have since 2012 exceeded the expenditure benchmark by 6.5 p.p. (Figure 3), having a negative effect on the balance in the amount of 2.4 % of GDP (Figure 4).** With respect to the expenditure benchmark the CBR also took into consideration, in addition to the effect of the lower contributions to the fully-funded pillar of the pension system, higher spending on national co-financing to EU funds, associated with higher tax revenues, and the improved effectiveness in VAT collection, deemed a government measure for the purposes of the evaluation, all of which reduced the negative effect of the deviation on the balance down to 1.5 % of GDP.

Beyond the evaluation of these two indicators, the CBR also took into account the effect of likely financial corrections associated with irregularities in the drawing of EU funds under the 2nd programming period. On top of that, the CBR also considered the fact that the debt still keeps within the sanction thresholds set by the Fiscal Responsibility Act[5] and that no sufficient measures to reduce the debt have been adopted so far. **Having considered all relevant factors, the CBR concludes that a significant deviation from the adjustment path occurred in 2015 and that it would be necessary to trigger the correction mechanism.**

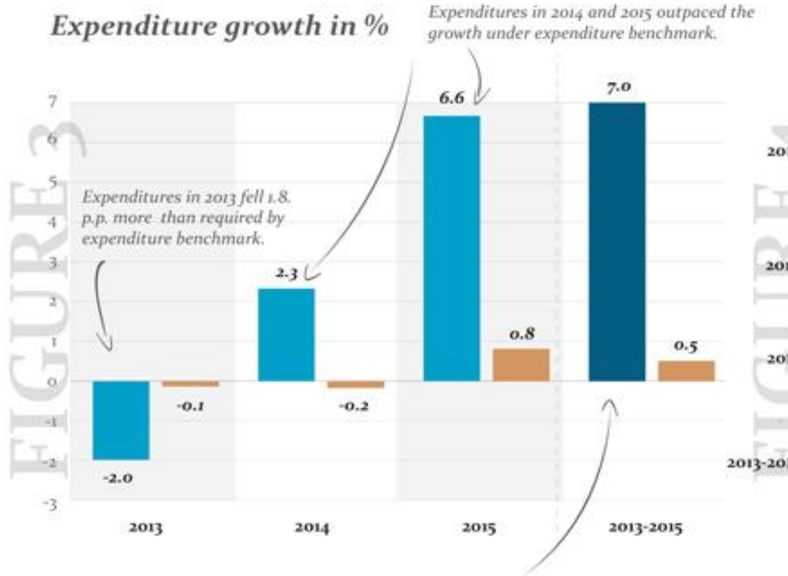
**After updating its 2015 evaluation, the Ministry upheld its conclusions from the June evaluation and has not proposed activation of the correction mechanism.** The conclusions presented in the Ministry and CBR evaluations differ due to a different assessment of the effect of the corrections to EU funds in the calculation of the structural balance and a different assessment of additional factors. According to the Ministry, the significant deviation in the case of the structural balance improved to a non-significant one when compared to the evaluation of June 2016, while a significant deviation was confirmed in the case of expenditures. In its overall evaluation, the Ministry holds that the deviation from the original adjustment path towards MTO set for 2017 is only temporary and not decisive in terms of adequate pace towards having a balanced budget in the upcoming years. The primary reason is that updating the path towards achieving the MTO by 2019 has relaxed, in Ministry's opinion, the year-on-year need for consolidation.

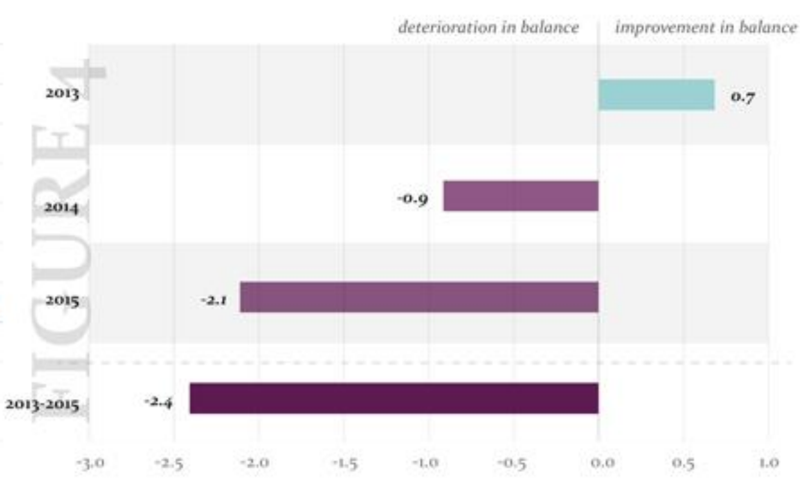
**According to the CBR, the Ministry took into consideration those factors that predominantly improve the assessment (i.e., reduce the deviation), while the positive effect of expenditures on national co-financing to EU funds is overestimated (Figure 5).** In contrast to the CBR evaluation, the Ministry did not consider, in its overall assessment, additional windfall budgetary revenues, impacts of measures with no effect on the long-term sustainability, and potential future corrections which, in CBR's opinion, may confirm or even increase the deviation in the structural balance. On the other, the Ministry adjusts the structural balance for the effect of increased national co-financing which the CBR considers to have an almost neutral effect on the structural balance. One of the main reasons for not triggering the correction mechanism is also the postponement of the medium-term objective from 2017 to 2019. The 2015 evaluation is based on the adjustment path and objectives valid at that time, as accepted also by the Ministry. On that account, the postponement of the deadline for the accomplishment of the medium-term objective should not constitute grounds for not triggering the correction mechanism. Such an approach would practically mean that the Ministry of Finance and/or the government can avoid activation of the correction mechanism and that the national legislation is merely formal in this respect, without being actually enforceable.

The correction mechanism is defined by Act No. 523/2004 on budgetary rules and consists of determining a public expenditure ceiling and measures to be taken during the period of correcting a significant deviation to prevent postponement of the medium-term objective. In a standard situation, the correction mechanism should eliminate the deviation with a view to

[5] Constitutional Act No. 493/2011 on fiscal responsibility.

## Expenditure benchmark: A higher growth in expenditures in 2014 and 2015 led to a significant deviation with a negative impact on the balance at the level of 2.4 % of GDP




Between 2013 and 2015, the expenditures grew 6.5 p.p. more than as required under the expenditure benchmark.

If the expenditures growth was in line with the expenditure benchmark, the deficit would be 2.4 % of GDP lower in 2015, totalling 0.3 % GDP (the deficit reached 2.7 % HDP in 2015).

*Actual pace of expenditure growth*

*Expenditure benchmark (permitted growth in expenditures)*

## Unlike the CBR, the Ministry considered mainly factors reducing the significant deviation in its evaluation

FIGURE 5

| | CBR | Ministerstvo financií Slovenskej republiky |
|---|---|---|
| Change in structural balance | significant deviation | deviation |
| Expenditure benchmark | significant deviation | significant deviation |
| **Additional factors** | **CBR took into account effects increasing as well as decreasing the deviation** | **MF SR took into account only effect decreasing the deviation** |
| Changes in fully-funded pension pillar | − | not assessed |
| Costs of nuclear decommissioning | − | not assessed |
| Extended bank levy | − | not assessed |
| Windfall revenues | − | not assessed |
| Debt within "debt brake" sanction thresholds | − | not assessed |
| Higher expenditures on co-financing | + | + + |
| More effective VAT collection | + | + |
| Time consistent recording of corrections to EU funds | − + | + |
| MTO deadline postponed from 2017 to 2019 | irrelevant | + |
| **Final evaluation** | **significant deviation - activation of correction mechanism required** | **no significant deviation** |

− + *effects increasing/decreasing deviation in structural balance or expenditure benchmark*

*Measures taken in these areas contributed to an improvement in structural balance between 2013 and 2015. The improvement is only temporary, as they will lead to higher expenditures in future. Their effect is neutral in the long term.*

*The 2013-2015 contribution of windfall revenues to the balance improvement was 1.3 % of GDP. The structural balance should thus improve more significantly against the adjustment path set.*

*Higher drawn on EU funds associated with higher expenditures on co-financing increases tax revenues. Consequently, impact on general government structural balance is neutral. However, MF SR took into account only higher expenditures and so overestimated the impact on structural balance.*

*Due to the lack of complete information about shifts in present corrections (reducing the deviation) and the missing estimate of future corrections (increasing the deviation), the CBR considered the actual level of corrections under ESA2010. According to the CBR, this level gives a more precise picture of the expected effect of corrections on structural balance in 2015. The Ministry only considered the time shift in present corrections which reduce the deviation.*

*The 2015 evaluation is based on the adjustment path and objectives valid at that time, as accepted also by the Ministry, therefore, postponing the MTO deadline should not constitute grounds for not triggering the correction mechanism.*

*The CBR proposes to trigger the correction mechanism in the form of binding expenditure ceilings at the level of the approved 2017-2019 budget.*

attaining the medium-term objective by the original deadline of 2017. Because, in the meantime, the medium-term objective has been put off to 2019, **it would be advisable to set the expenditure ceiling at least at the current level planned in the approved General Government Budget for 2017-2019**. Even though risks were identified by the CBR and additional measures need to be implemented in order to accomplish budgetary objectives, setting the ceiling may, including according to the CBR evaluation, lead towards meeting the medium-term objective in 2019. In this manner, further postponement of the medium-term objective could, at least partially, be prevented in the future in line with the fiscal compact principle.

The CBR evaluation, as well as the proposal to trigger the correction mechanism, are based on the common principles on national fiscal correction mechanisms, published by the European Commission as part of the implementation of the fiscal compact[6]. **The correction mechanisms should be instrumental in providing critical elements of stability in the budgetary framework, so as to prevent the "moving-target syndrome" typically associated in response to budgetary slippages.** To that aim the correction mechanisms should ensure adherence to key fiscal targets as set before the occurrence of the significant deviation[7].

Under the "comply or explain" principle, the Ministry is required to publish its position on an evaluation prepared by the CBR. In the position it published in August 2016 in response to the CBR evaluation of July 2016, the Ministry repeated its reasons for not triggering the correction mechanism. It provided no comments on the reasons presented by the CBR which had led to the different conclusion. **In CBR's opinion, the Ministry did not comply with said principle, since it failed to justify its rather arbitrary choice of relevant factors.** Equally, the Ministry did not consider the factors with negative impacts, highlighted by the CBR in its July report, in its evaluation of November 2016.

[6] The fiscal compact is part of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union signed by twenty-five EU Member States, including Slovakia, on 2 March 2012.

[7] Principle 4: *"[Nature of the correction] The size and timeline of the correction shall be framed by predetermined rules. Larger deviations from the medium-term budgetary objective or from the adjustment path towards it shall lead to larger corrections. Restoring the structural balance at or above the MTO within the planned deadline, and maintaining it there afterwards, shall provide the reference point for the correction mechanism. The correction mechanism shall ensure adherence to critical fiscal targets as set before the occurrence of the significant deviation, thereby preventing any lasting departure from overall fiscal objectives as planned before the occurrence of the significant deviation. At the onset of the correction Member States shall adopt a corrective plan that shall be binding over the budgets covered by the correction period."*

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